

INOVA HEALTH SYSTEM

**Consolidated Financial
Statements and Other
Supplementary Information**

**Period Ended
March 31, 2019**

Inova Health System
Consolidated Financial Statements
and Other Supplementary Information
March 31, 2019 and 2018

Consolidated Financial Statements

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Inova Health System
Management's Discussion and Analysis of Results of Operations and Financial Position
As of and for the Three Months Ended March 31, 2019

Introduction

Inova Health System ("IHS") is an integrated, not-for-profit health care delivery system that owns, operates and manages clinical, educational, research, and hospital facilities located in northern Virginia, serving northern Virginia, the Washington, D.C. metropolitan area, and contiguous counties in Virginia and Maryland. The principal line of business for IHS is the delivery of acute care hospital services at locations in northern Virginia. IHS also operates an integrated network of health services including ambulatory care, home health care, senior services, assisted living, and other health related services. IHS maintains a group of primary care and specialty physicians operating as the Inova Medical Group as well as a clinically integrated physician network known as Signature Partners and Innovation Health ("Innovation"), a joint venture with Aetna offering commercial health insurance plans.

The following discussion and analysis provides information that IHS management believes is relevant to an assessment and understanding of IHS' results of operations and financial position. This analysis should be read in conjunction with IHS' financial statements for the three months ended March 31, 2019 and 2018. The discussion and analysis focuses on IHS as a whole, which management believes provides a fair description and analysis, in all material respects, of the Obligated Group's results of operations and financial condition, insofar as the Obligated Group represents approximately 94% of total operating revenues and nearly 100% of unrestricted net assets of IHS as of and for the three months ended March 31, 2019.

Results of Operations as of and for the three months ended March 31, 2019 and 2018

Overall, IHS reported strong operating results achieving Operating and Cash Flow margins of 7.2% and 15.1% respectively. Both profitability indicators exceeded prior year performance.

Operating Revenues. Total operating revenues for IHS for the three months ended March 31, 2019 were \$898 million, an 8.2% increase from prior year. Net Patient Service Revenue increased 9.0% primarily due to significant increases in patient activity compared with the prior year, including:

- 4.7% increase in inpatient admissions,
- 2.2% and 2.7% increase in inpatient and outpatient surgeries, respectively,
- 9.9% increase in outpatient referred visits

In addition to strong volumes, revenue increased over \$8 million in the first quarter due to Virginia's Medicaid expansion and rate improvement.

Operating Expenses Total operating expenses for the three months ended March 31, 2019 were \$833 million, an increase of 6.2% over the comparable period in 2018. Salaries and benefits increased \$22 million, or 5.2%, primarily due to merit and market based pay adjustments, as well as increased staffing costs associated with increased volumes. Other operating expenses increased 8.2% primarily resulting from increases in medical supplies and other costs also associated with increased surgical costs and other patient activity.

Operating Income was \$64 million, or 7.2% of total operating revenues, for the three months ended March 31, 2019, as compared to \$45 million, or 5.4% of total operating revenues, in 2018. The increase in operating earnings was principally driven by overall increases in patient volume.

Investment Income and Other, net. Total *Investment Income and Other, net*, was \$378 million resulting in a net margin of 34.4% for the year. This compares favorably to a net margin of 7.8% for the year ending March 2018. Global equity and global fixed income markets were up strongly in the first quarter of 2019, and over the trailing twelve months, compared to prior periods. The total return for the Strategic fund was 9.0% for the first quarter of 2019 compared with a benchmark of 8.5%.

Financial Position as of March 31, 2019

Current Assets and Liquidity. IHS' balance sheet remains strong, with significant unrestricted cash and investments at March 31, 2019 of \$5.3 billion, of which \$2.5 billion represents investments that can be liquidated within 3 days. Operating cash flow remained strong at \$85 million for the quarter.

Investments. The following table summarizes the asset allocation for the Strategic Fund and the Capital Fund, which together comprised the Board designated funds as of March 31, 2019 (dollars in thousands):

	<u>Amount</u>	<u>%</u>
<u>Strategic Fund</u>		
Cash and cash equivalents	\$ 307,654	6.2%
Fixed income	674,560	13.6%
Public equity	2,697,797	54.5%
Growth hedge funds	367,693	7.4%
Private equity	176,814	3.6%
Diversifying hedge funds	473,865	9.6%
Real assets	76,771	1.6%
	<u>4,775,154</u>	96.5%
<u>Capital fund</u>	172,395	3.5%
Total	<u>\$ 4,947,549</u>	100%

Fixed income securities are primarily investment-grade U.S. bonds with maturities ranging from 1 year to 30 years. Public equity securities are typically exchange traded U.S. and non-U.S. stocks. Hedge funds include strategies with moderate to low correlation with more

traditional equity and fixed income sectors. Private equity includes early stage venture capital and buyout funds.

IHS maintains a separate portfolio comprised of limited maturity, high quality bonds (Capital Fund). This fund was established to ensure that IHS would have sufficient liquidity to complete critical construction projects in the event of a major financial market disruption.

Property, Plant, and Equipment. Capital expenditures were \$107 million for the three months ended March 31, 2019, which included \$77 million of major hospital expansion and renovation projects at the Inova Fairfax and Loudoun Hospital's and the ICPH campus including \$21 million for the new Inova Fairfax Hospital Schar Cancer Institute. The remainder of capital expenditures related to information technology projects, and routine capital replacement.

All planned capital expenditures are regularly evaluated based upon business need, economic conditions and IHS' financial position and will be financed through a combination of operating cash flow, donations, tax-exempt borrowing and cash reserves if necessary.

Debt Structure and Liability Management. At March 31, 2019, total long-term debt outstanding, including financing obligations, was approximately \$2.0 billion, or 24.7% of capitalization. IHS' capital structure is diversified to mitigate interest rate risk by utilizing different modes and durations of long-term debt as well as interest rate swaps.

As of March 31, 2019, 70% of IHS underlying long-term debt is in some form of fixed rate. Inova also holds two fixed-payer swap contracts and one variable-payor swap contract with a combined notional amount of \$219. The swaps had a combined fair market value of +\$2.7 million as of March 31, 2019. IHS' effective fixed rate debt percentage was approximately 77% as of March 31, 2019.

IHS maintains a self-liquidity taxable commercial paper ("CP") program with \$100.0 million outstanding of short term debt having maturity dates from 1 to 270 days. The outstanding CP is included in *Notes payable and other liabilities* in the current liabilities section of the Consolidated Balance Sheets.

Adoption of New Leasing Standard

On January 1, 2019, IHS adopted ASU No. 2016-02, *Leases (Topic 842)*, using the modified retrospective approach. This ASU requires the rights and obligations arising from the lease contracts, including existing and new arrangements, to be recognized as assets and liabilities on the Consolidated Balance Sheets. The ASU also requires disclosures to help financial statement users better understand the amount, timing, and uncertainty of cash flows arising from leases. The adoption of the ASU resulted in the recognition of approximately \$140 million of lease assets and lease liabilities in the accompanying Consolidated Balance Sheets.

Executive Leadership Changes

In March 2019, Richard Magenheimer announced his intention to retire as Chief Financial Officer (“CFO”) effective June 2019. IHS has initiated a national search for his successor.

Other Financial Information

The following are selected financial indicators for IHS as of and for the periods ended March 31, 2019 and 2018:

	<u>2019</u>	<u>2018</u>
Operating Margin ¹	7.2%	5.4%
Operating Cash Flow Margin ²	15.1%	13.7%
Net Margin ³	34.4%	7.8%
Net Days in Accounts Receivable ⁴	37	37.5
Days in Unrestricted Cash ⁵	608.8	635.0
Unrestricted Cash to Debt ⁶	2.7	2.9
Debt Service Coverage Ratio ⁷	4.9x	11.6x

1 Operating income divided by operating revenue

2 Operating income plus interest expense, plus depreciation and amortization expense divided by total operating revenue

3 Excess revenues over expenses divided by total operating revenue plus investment income and other, net

4 Net Patient Receivables divided by three-month average daily net patient service revenue

5 Cash and short-term investments plus unrestricted cash reserves plus unrestricted long-term investments divided by average daily operating expenses excluding depreciation and amortization expense

6 Cash and short-term investments plus unrestricted cash reserves plus unrestricted long-term investments divided by long term debt plus financing obligation plus commercial paper borrowings

7 Income Available for Debt Service divided by long-term debt service requirement (calculated on a rolling 12-month basis).

Inova Health System
Consolidated Balance Sheets
March 31, 2019 and December 31, 2018
(in thousands)

	March 31, 2019 (Unaudited)	December 31, 2018 (Restated)
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 303,019	\$ 333,100
Assets whose use is limited, current	198,955	198,955
Patient accounts receivable, net	356,148	321,920
Other current assets	155,105	136,930
Total Current Assets	<u>1,013,227</u>	<u>990,905</u>
Property, Equipment and Leasehold Interests, net	2,430,135	2,379,913
Assets Whose Use Is Limited		
Held by bond trustee	117,859	135,679
By board for plant replacement and expansion	4,775,154	4,400,115
By board for construction projects	172,395	169,313
By donor	137,274	135,341
For professional liability	86,982	80,422
For health plan liability	537	534
	<u>5,290,201</u>	<u>4,921,404</u>
Less amounts required to meet current obligations	(198,955)	(198,955)
Total Assets Whose Use Is Limited, noncurrent	<u>5,091,246</u>	<u>4,722,449</u>
Other Assets		
Investments in and receivables from affiliates	69,038	63,053
Goodwill and other intangible assets	41,960	42,233
Interest rate swap	3,564	6,522
Long-term investments	52,257	49,766
Other long-term assets	82,944	87,433
Long-term right of use asset	136,241	144,164
Total Other Assets	<u>386,004</u>	<u>393,171</u>
TOTAL ASSETS	<u><u>\$ 8,920,612</u></u>	<u><u>\$ 8,486,438</u></u>
LIABILITIES AND NET ASSETS		
Current Liabilities		
Accounts payable and other accrued expenses	\$ 419,075	\$ 406,078
Third-party settlements	44,619	46,657
Notes payable and other liabilities	115,469	112,849
Current lease liability	34,612	36,189
Current portion of long-term debt	228,437	228,429
Total Current Liabilities	<u>842,212</u>	<u>830,202</u>
Non-current Liabilities		
Long-term debt, less current portion	1,456,580	1,463,060
Interest rate swap	910	-
Financing obligation	184,281	184,461
Long-term lease liability	112,880	119,688
Other non-current obligations	72,700	79,644
Total Non-current Liabilities	<u>1,827,351</u>	<u>1,846,853</u>
Net Assets		
Without donor restrictions	6,036,309	5,597,522
With donor restrictions	193,617	191,237
Total Net Assets Attributable to IHS	<u>6,229,926</u>	<u>5,788,759</u>
Non-controlling Interest	21,123	20,624
Total Net Assets	<u>6,251,049</u>	<u>5,809,383</u>
TOTAL LIABILITIES AND NET ASSETS	<u><u>\$ 8,920,612</u></u>	<u><u>\$ 8,486,438</u></u>

Inova Health System
Consolidated Statements of Operations and
Changes in Assets Without Donor Restrictions
For the Three Months Ended March 31, 2019 and 2018
(Unaudited, in thousands)

	<u>2019</u>	<u>2018</u>
Operating Revenues		
Net patient service revenue	\$ 865,634	\$ 794,212
Other operating revenue	32,174	35,692
Total Operating Revenues	<u>897,808</u>	<u>829,904</u>
Operating Expenses		
Salaries and benefits	437,286	415,576
Other operating expenses	325,118	300,367
Depreciation and amortization	57,186	56,437
Interest	13,811	12,353
Total Operating Expenses	<u>833,401</u>	<u>784,733</u>
Operating Income	64,407	45,171
Investment income and other, net	377,989	24,963
Excess of Revenues over Expenses	<u>442,396</u>	<u>70,134</u>
Less: Non-controlling Interest	(3,641)	(3,320)
Excess of Revenues over Expenses, Attributable to IHS	<u>438,755</u>	<u>66,814</u>
Other	32	(577)
Increase in Net Assets Without Donor Restrictions	<u>\$ 438,787</u>	<u>\$ 66,237</u>

Inova Health System
Consolidated Statements of Cash Flows
For the Three Months Ended March 31, 2019 and 2018
(Unaudited, in thousands)

	<u>2019</u>	<u>2018</u>
Operating Activities		
Change in net assets	\$ 441,666	\$ 83,886
Adjustments to reconcile change in net assets to net cash provided by operating activities		
Depreciation and amortization	57,186	56,437
Net realized and unrealized gains on investments	(371,475)	(10,491)
Change in fair value of interest rate swaps	3,868	(5,388)
Equity investment (gains)/losses, net	(2,579)	2,875
Increase in accounts receivable and third-party settlements, net	(38,649)	(8,499)
Increase/(Decrease) in other current assets	(8,889)	5,023
Increase in accounts payable and other current liabilities	13,024	13,423
Decrease in estimated professional liability and other deferred liability items	(3,274)	(2,042)
Restricted contributions and investment income	(4,824)	(3,086)
Other	(1,458)	(19,123)
Net Cash Provided by Operating Activities	<u>84,596</u>	<u>113,015</u>
Investing Activities		
Capital expenditures	(106,995)	(129,031)
Investments in and advances to joint ventures and affiliates	(3,405)	(10,597)
Purchases of marketable securities	(829,247)	(327,934)
Proceeds from sale of marketable securities	827,361	313,959
Other	2,550	11,295
Net Cash Used in Investing Activities	<u>(109,736)</u>	<u>(142,308)</u>
Financing Activities		
Principal payments on long-term debt	(4,802)	(4,833)
Restricted contributions and investment income	4,065	3,086
Other	(4,204)	7,363
Net Cash (Used in)/Provided by Financing Activities	<u>(4,941)</u>	<u>5,616</u>
Net Decrease in Cash and Cash Equivalents	(30,081)	(23,677)
Cash and cash equivalents at beginning of period	<u>333,100</u>	<u>232,528</u>
CASH AND CASH EQUIVALENTS AT END OF PERIOD	<u><u>\$ 303,019</u></u>	<u><u>\$ 208,851</u></u>

**Other Supplementary
Information**

**Period Ended
March 31, 2019**

Inova Health System Obligated Group
Consolidated Balance Sheets
March 31, 2019 and December 31, 2018
(in thousands)

	March, 31 2019 (Unaudited)	December 31, 2018 (Restated)
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 277,585	\$ 302,609
Assets whose use is limited, current	198,955	198,955
Patient accounts receivable, net	341,351	307,466
Other current assets	138,892	123,084
Total Current Assets	<u>956,783</u>	<u>932,114</u>
Property, Equipment and Leasehold Interests, net	2,384,359	2,332,600
Assets Whose Use Is Limited		
Held by bond trustee	117,859	135,679
By board for plant replacement and expansion	4,772,427	4,397,693
By board for construction projects	172,395	169,313
By donor	119,003	117,732
	<u>5,181,684</u>	<u>4,820,417</u>
Less amounts required to meet current obligations	(198,955)	(198,955)
Total Assets Whose Use Is Limited, noncurrent	<u>4,982,729</u>	<u>4,621,462</u>
Other Assets		
Investments in and receivables from affiliates	144,574	138,474
Goodwill and other intangible assets	30,335	30,474
Interest rate swap	3,564	6,522
Long-term investments	52,256	49,765
Other long-term assets	128,792	133,146
Long-term right of use asset	97,876	103,710
Total Other Assets	<u>457,397</u>	<u>462,091</u>
TOTAL ASSETS	<u><u>\$ 8,781,268</u></u>	<u><u>\$ 8,348,267</u></u>
LIABILITIES AND NET ASSETS		
Current Liabilities		
Accounts payable and other accrued expenses	\$ 394,869	\$ 380,628
Third-party settlements	44,316	46,354
Notes payable and other liabilities	109,613	108,716
Current lease liability	24,239	25,269
Current portion of long-term debt	227,210	227,210
Total Current Liabilities	<u>800,247</u>	<u>788,177</u>
Non-current Liabilities		
Long-term debt, less current portion	1,450,606	1,456,776
Interest rate swap	910	-
Financing obligation	184,281	184,461
Long-term lease liability	79,964	84,855
Other non-current obligations	53,901	58,267
Total Non-current Liabilities	<u>1,769,662</u>	<u>1,784,359</u>
Net Assets		
Without donor restrictions	6,042,574	5,608,819
With donor restrictions	168,785	166,912
Total Net Assets	<u>6,211,359</u>	<u>5,775,731</u>
TOTAL LIABILITIES AND NET ASSETS	<u><u>\$ 8,781,268</u></u>	<u><u>\$ 8,348,267</u></u>

NOTE: The Obligated Group consists of Inova Health System Foundation, Inova Health Care Services and Loudoun Hospital Center, and the financial statements presented for the Obligated Group includes only their accounts, which includes their investment interest in controlled, affiliated entities, but does not include in the revenues, expenses, assets or liabilities of the Obligated Group the revenues, expenses, assets or liabilities of any of those controlled, affiliated entities.

Inova Health System Obligated Group
Consolidated Statements of Operations and
Changes in Net Assets Without Donor Restrictions
For the Three Months Ended March 31, 2019 and 2018
(Unaudited, in thousands)

	<u>2019</u>	<u>2018</u>
Operating Revenues		
Net patient service revenue	\$ 817,821	\$ 745,938
Other operating revenue	30,336	25,897
Total Operating Revenues	<u>848,157</u>	<u>771,835</u>
Operating Expenses		
Salaries and benefits	409,954	386,654
Other operating expenses	313,058	280,108
Depreciation and amortization	54,947	54,008
Interest	13,686	12,118
Total Operating Expenses	<u>791,645</u>	<u>723,958</u>
Operating Income	56,512	38,877
Investment income and other, net	337,349	32,171
Excess of Revenues over Expenses	<u>433,861</u>	<u>71,048</u>
Other	(106)	(496)
Increase in Net Assets Without Donor Restrictions	<u>\$ 433,755</u>	<u>\$ 70,552</u>

NOTE: The Obligated Group consists of Inova Health System Foundation, Inova Health Care Services and Loudoun Hospital Center, and the financial statements presented for the Obligated Group includes only their accounts, which includes their investment interest in controlled, affiliated entities, but does not include in the revenues, expenses, assets or liabilities of the Obligated Group the revenues, expenses, assets or liabilities of any of those controlled, affiliated entities.

Inova Health System Obligated Group
Consolidated Statements of Cash Flows
For the Three Months Ended March 31, 2019 and 2018
(Unaudited, in thousands)

	2019	2018
Operating Activities		
Change in net assets	\$ 435,628	\$ 84,382
Adjustments to reconcile change in net assets to net cash provided by operating activities		
Depreciation and amortization	54,947	54,008
Net realized and unrealized gains on investments	(364,387)	(12,177)
Change in fair value of interest rate swaps	3,868	(5,388)
Equity investment gains, net	(8,085)	(2,693)
Increase in accounts receivable and third-party settlements, net	(38,305)	(2,922)
Increase in accounts payable and other current liabilities	17,733	18,810
(Decrease)/Increase in estimated professional liability and other deferred liability items	(4,536)	7,993
Decrease in intangibles and other assets	(7,110)	(7,984)
Restricted contributions and investment income	(4,348)	(2,714)
Other	5,073	(11,214)
Net Cash Provided by Operating Activities	90,478	120,101
Investing Activities		
Capital expenditures	(106,705)	(127,926)
Investments in and advances to joint ventures and affiliates	1,985	(4,532)
Purchases of marketable securities	(823,192)	(321,115)
Proceeds from sale of marketable securities	821,749	305,350
Other	(2,595)	589
Net Cash Used in Investing Activities	(108,758)	(147,634)
Financing Activities		
Principal payments on long-term debt	(4,500)	(4,500)
Restricted contributions and investment income	3,601	2,714
Other	(5,845)	(15)
Net Cash (Used in)/Provided by Financing Activities	(6,744)	(1,801)
Net Decrease in Cash and Cash Equivalents	(25,024)	(29,334)
Cash and cash equivalents at beginning of period	302,609	189,263
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 277,585	\$ 159,929

NOTE: The Obligated Group consists of Inova Health System Foundation, Inova Health Care Services and Loudoun Hospital Center, and the financial statements presented for the Obligated Group includes only their accounts, which includes their investment interest in controlled, affiliated entities, but does not include in the revenues, expenses, assets or liabilities of the Obligated Group the revenues, expenses, assets or liabilities of any of those controlled, affiliated entities.